2022
Letter to Investors

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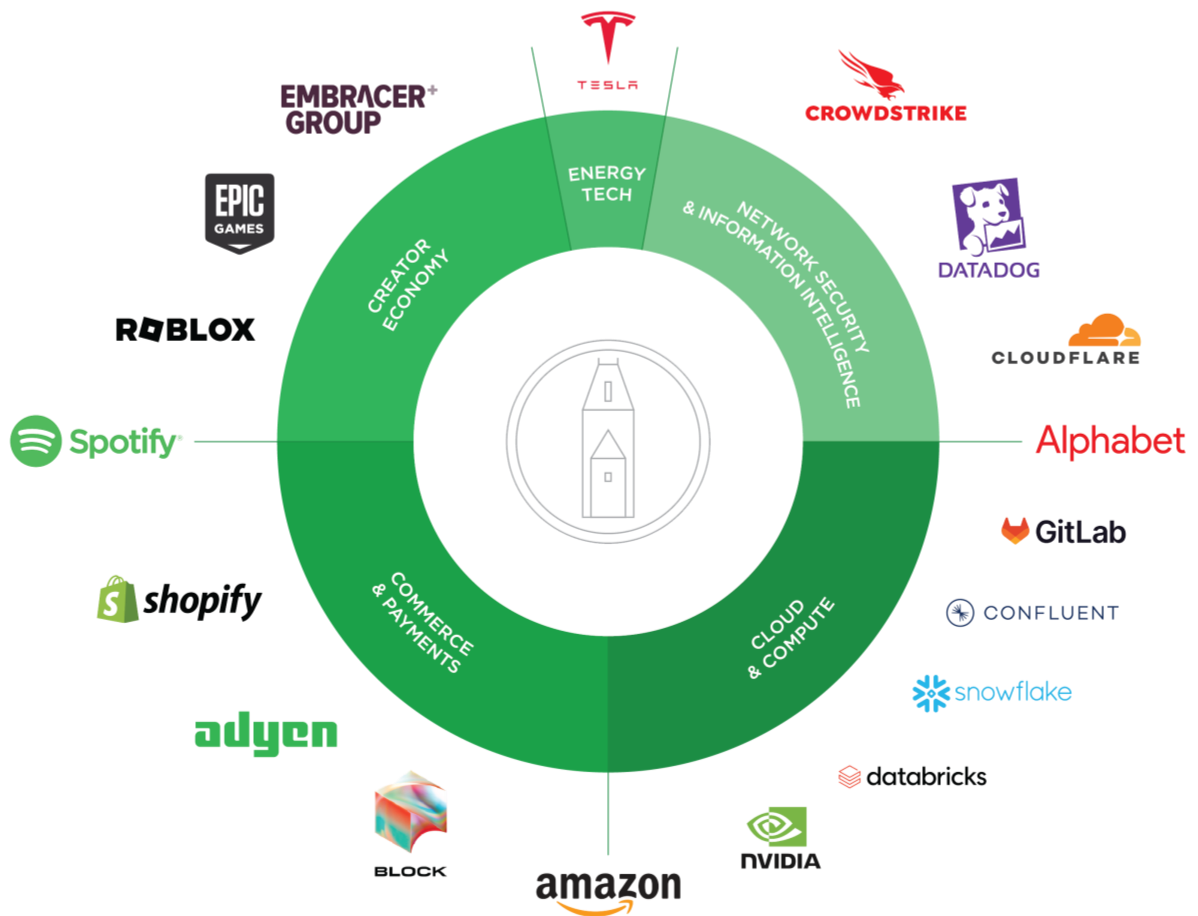
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January 18, 2023

Dear Investor,

In 2022, the return of the Guardian Fund was -67.85%, measured in euros and net of fees and expenses. This compares to -18.51% for the S&P 500 Index, measured in U.S. dollars, and including dividends, and to -32.97% for the Nasdaq 100.

The return of the Knight Tech Fund - the fund that owns shares in Epic Games and Databricks - was -62.42%, net of fees and expenses. This compares to -32.97% for the Nasdaq 100, measured in U.S. dollars, and including dividends.

The Past Year

It feels surreal to report such numbers. For years, we shared that investors should be willing to go through a 50% drawdown several times in their lives. Nonetheless, experiencing such a significant drawdown is painful. The temptation becomes to sell in order to stop the pain of having to face lower prices.

In 2021, we have been complacent regarding valuations. In prior years, we made the mistake of selling good businesses because the valuation appeared rich. Growth would surprise and prices that seemed expensive were in fact reasonable. During the pandemic, valuations went up significantly and expected returns declined. As a result, we were borrowing returns from the future.

Over the past few years, we understood how certain asset classes were pumped up by low interest rates and how rising interest rates would put pressure on valuations. We underestimated the macroeconomic regime change and the magnitude by which especially tech stocks would get hammered. Going into the storm, we were too confident in our strategy to err on the side of not selling a good business. High valuations provided insufficient margin of safety when the pendulum of valuations started to swing to the other side.

In a short timeframe, the economic variables that set valuation levels changed significantly. As stocks plunged, we kept our eyes on the individual businesses and maintained positions rather than selling shares with the goal to reduce possible further downside. We were early to deploy incremental capital. In 2022, we must have been among the minority that were net buyers of equities.

In this letter, we will not contribute to the macroeconomic discussion as we have got little to add to all opinions. Nobody has any idea what will happen to stock prices, inflation, interest rates, or the economy in 2023 and beyond. Sentiment is fearful and consensus is that stormy weather will

continue for some time. Over the coming years, the environment for equities, and asset prices in general, is likely to be more challenging than over the past decade. We need profitable growth to get ahead.

The Fear is about Growth

Higher interest rates only partly explain today's lower valuations. The real fear is about growth. Indeed, growth is decelerating at most businesses; all are dealing with current challenges such as inflation, cost optimization, and supply chain constraints. Nonetheless, all portfolio businesses continued to grow in 2022.

We own several businesses at which growth slowed down more than expected. This had a negative impact on margins as cost structures have not yet adapted.

For instance, revenue growth at Shopify decelerated post-Covid as volumes shifted back to physical locations. A shift was expected but the amount of slowdown in digital commerce even surprised management as the penetration of online commerce reverted to the long-term trendline.

Growth has also slowed down at the best enterprise software businesses with mission-critical products. The three dominant cloud businesses of Amazon, Microsoft, and Google reported lower growth in 2022. The hyperscalers and their clients are optimizing costs.

When share prices and growth decline, negative narratives start to dominate, and financial analysts start to downward adjust business estimates. As a result, expected returns start to correlate with prices instead of showing an inverse relationship.

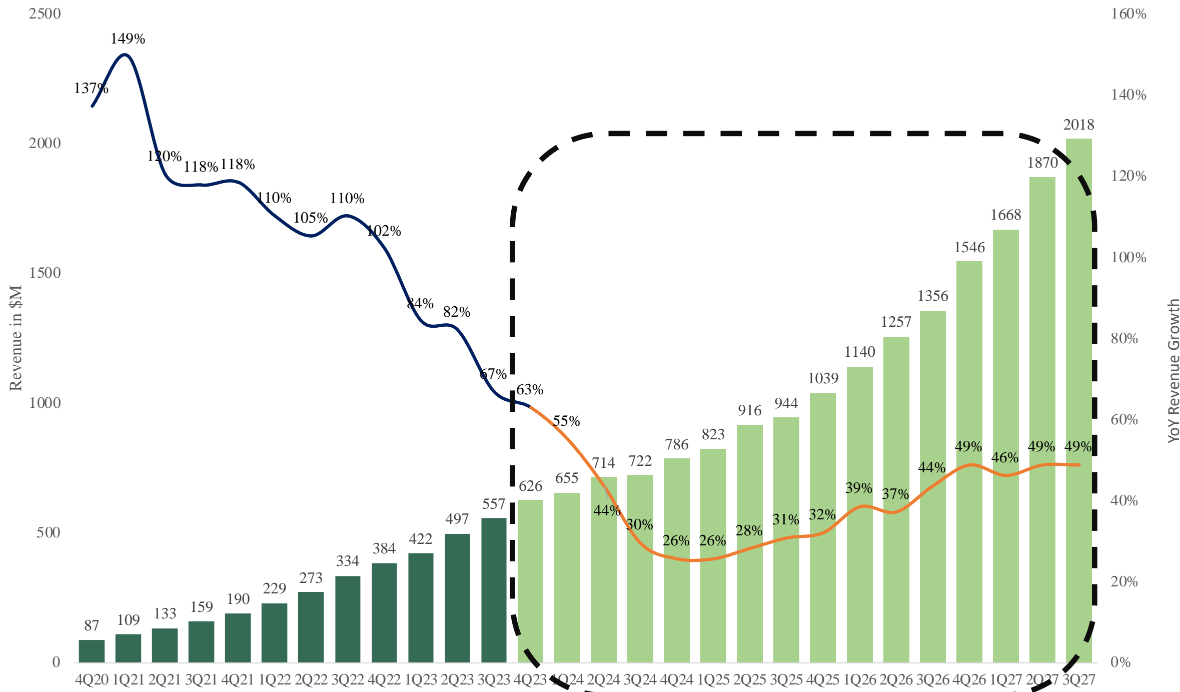
A slowdown in growth at thriving businesses creates an opportunity for investors who have a vision on where a business is heading through the cycle and for those who have a view on whether the deceleration in a business is a temporary adjustment or a permanent trend.

In 2022, growth at YouTube was almost absent. Has the platform become less relevant? User engagement is up yet advertising budgets are under pressure. When ad budgets come back, they disproportionally go to the platforms that offer the highest return on ad spend. Similarly, growth at AWS decelerated. Has Amazon's cloud platform become less relevant to society?

Fluctuating Growth: Salesforce as an Example

It becomes a challenge to model cash flows of a business that will experience a slowdown in growth for a couple of quarters followed by a reacceleration of growth.

As a thought experiment, we extrapolated Snowflake's future revenue growth based on Salesforce's growth during the 2008/09 recession. The companies and times are different. However, we think that Snowflake is likely to show a similar deceleration followed by an acceleration of growth over the coming years.



Source: Company filings

More important than revenue growth is the growth in free cash flow (FCF) *per share*. Here, Salesforce's history can teach us something as well. In 2009, Salesforce reported FCF of USD 220m and had 508m shares outstanding. By 2021, FCF grew over 2,000% and FCF per share grew 1,100% as the number of shares outstanding doubled to about 1 billion (part of the revenue growth has been acquired). Since 2009, the share price is up 900% as the FCF multiple went from 45x in 2009 to 25x today.

The drawdown we have experienced in 2022 is not unprecedented. In 2008 and 2009, the share price of Salesforce went from USD 18.20 to USD 5.58 - down 70% in five months - before rebounding to USD 18.17 thirteen months later and growing to USD 148 in January 2023 (after being down 50% since October 2021).

We need to own companies that have a long runway of durable growth ahead and that have the potential to compound earnings like Salesforce did over the past fifteen years. Some of our portfolio companies are scaling faster than Salesforce did when it was younger.

Intelligent Capital Allocation

With growth likely to settle at a lower level in the near-term, operational efficiency and intelligent capital allocation are essential to create value. Many tech companies have not yet shown exceptional skills in allocating capital.

Sinking share prices are exposing the significant costs of share-based compensation. Share dilution along the way is acceptable if more value is created than given away by issuing shares. Most portfolio businesses like Snowflake, Spotify, and Adyen managed to stay relatively lean. Also share-based compensation is at a more acceptable level (e.g., 1-2% at Snowflake while growth is above 40% YoY).

Most software companies emerged in a time of low inflation, low interest rates, and abundant liquidity. Competition for talent drove compensation packages. The quality of management matters more than ever because intelligent capital allocation and willingness to explore pricing power make more of a difference when share prices become attractive and in inflationary times. Intelligent capital allocation is rare as most CEOs are talented founders or software engineers rather than capital allocators.

The awareness of operational efficiency has grown at many businesses. Shareholder letters from long-term oriented investors like TCI help to nudge managements to act. Elon Musk's first-principle approach at Twitter to what is essentially required has not gone unnoticed in the industry. The question is if the fatter companies can culturally cope with a new environment and can get back to a 'Day 1' mindset.

As the earnings yields of profitable tech businesses have risen, businesses with excess cash could do more share buybacks. This, combined with losing fat will be a powerful force driving share prices. Capital allocation over the next six months, will tell a lot about the quality of management. Recent buyouts from private equity firms like Thoma Bravo show that intrinsic values can be higher than share prices because new management can adjust costs and allocate capital.

Innovation, Competition & Controversy

It is interesting to experience the combination of a historic drawdown and significant innovation at various businesses that are active in expanding addressable markets.

When we reflect on the past year, it is difficult not to feel a sense of wonder regarding the magnitude of innovation taking place especially in AI. Large language models powered by transformer architectures - neural networks designed to model sequential data and generate a prediction of what comes next in a series – are improving at an impressive rate. The models have been growing by an order of magnitude every year as measured by parameter count, a rough proxy for the model's capability. The surprise in 2022 has been that models were getting smaller and more efficient so they can be run locally at lower costs.

On a weekly basis, researchers have published work that pushed the frontier of AI and that surprised even people working in this field. Together, large language models and code generated powerful new developments. For example, OpenAI's Codex Model, an AI model that can translate natural language into programming language - GitHub Copilot, a programming assistant - Dall-E2, a system that can create realistic images from a description in natural language - Stable Diffusion, an open-source text-to-image generator - and ChatGPT, a model that interacts in a conversational way. 2022 was a year of awakening in which the public got more exposure to AI products. It will be fascinating to see what 2023 will have in store when computers start speaking our language. Some bright minds think artificial general intelligence (AGI) may even be possible within a decade. The coming years will bring an unimaginable range of new utility and products.

When growth is slowing down and share prices plummet, more doubts arise about the competitive position of various businesses. Controversy around a stock is a constant factor and it may even be a necessary ingredient for outstanding long-term returns. Below, we will share two examples of current discussions about the long-term moat of two businesses.

Example 1: Google Search and ChatGPT

These days many people are discussing how OpenAI's ChatGPT may disrupt Google Search. The products coming from OpenAI are impressive and soon it will publish GPT-4 which will be another step up in performance.

In the field of AI, innovation is fast and tech capabilities will continue to outpace products. This means that there will be a constant stream of demos and products that can potentially compete with search as we know it. Any tech-driven business will eventually face technological redundancy, and the peak of Google Search's relevancy may have passed. However, innovation in the field does not mean that Google Search is suddenly done.

First, Google seems behind in some areas and is taking it seriously. Alphabet employs some of the world's brightest minds in AI and will come with their own comparable products in 2023. The recent products of Deepmind (acquired by Alphabet in 2014) are impressive (e.g. Flamingo and Gato). We wonder how far behind Alphabet's engineers are. Google will probably need closer interaction between the research and commercial people to shorten the time between

development of new models and implementation in (existing) products. New technologies need to result in an order of magnitude improvement.

Second, to replace Google Search, a product must achieve technological parity. Google Search is a sophisticated index of the web that has become good at the long tail of search. ChatGPT works well for certain queries. A natural language model can eloquently and authoritatively write a text that can be true or false because the model is trained on public information sources. Nonetheless, sometimes it is surprising how fast new companies can approach parity with the best-of-breed products. Besides technological parity, there are powerful incentives to overcome. For example, Alphabet is paying billions to Apple to be the default search engine on its devices.

Third, building state-of-the-art AI models is expensive because it requires a ton of compute. Therefore, scale and compute cost efficiency may be part of a moat. The question is to what extent data and feedback is a moat because the newer machine learning models have a better representation of the world and therefore are able to learn faster from human feedback.

Fourth, unique non-public datasets are valuable input for reinforcement learning. Both Google and Microsoft have such datasets (e.g., Gmail, Minecraft, Outlook). OpenAI's primary goal seems to be to create AGI. The greatest innovators do not automatically also build the best products and user interfaces. OpenAI's closer cooperation with the teams at Microsoft may enable faster and better product development and distribution.

Here is what ChatGPT itself replies to the prompt how it competes with Google Search: 'ChatGPT and Google Search are both powerful tools for retrieving information, but they are designed to work in different ways. Google Search is a web search engine that uses complex algorithms to find and rank relevant web pages in response to a user's query. ChatGPT, on the other hand, is a language generation model that generates human-like text based on the input it receives. It can respond to a wide variety of inputs, including questions and statements, and can engage in natural-sounding conversations. While Google Search is better suited for finding specific information on the web, ChatGPT is better suited for generating text and engaging in conversation.'

Alphabet shareholders need to continue to monitor the battlefield. The leading platforms must remain paranoid to stay ahead and it reminds us of the Red Queen in Alice in Wonderland saying: 'In my kingdom you have to run as fast as you can just to stay in the same place.'

On a side note, this Cambrian Explosion of AI is a tailwind for companies that are downstream of it like TSMC, Apple, and Nvidia. Software was memory-bound for a long time. Transformers, Stable Diffusion, and all language models are causing software to be more CPU- or GPU-bound. The explosion of demand for compute power creates more incentives to upgrade hardware including iPhones to have low latency. More efficient compute also creates cost savings in datacenters which could shorten the replacement cycle of hardware.

Example 2: Shopify and Buy with Prime

In 2022, Amazon launched Buy with Prime that allows Prime members (163.5m versus 100m in 2018) to shop on websites outside of Amazon, leveraging Amazon's logistics network. This action is a clear move to eat more of Shopify's cake whose mission it is to arm independent merchants. Buy with Prime offers enormous potential to Amazon's volumes as it opens the addressable market to all transactions outside of Amazon. Merchants are incentivized to use this service as they drive conversion through the trusted Prime membership and Amazon's logistics capabilities. Like at AWS, Amazon is no longer merely a retailer but has become an Infrastructure-as-a-Service platform. Being the low-cost provider of logistics infrastructure gives a natural moat.

Many Shopify merchants will consider using Amazon's fulfillment network which is likely to impact Shopify's volumes and take rate. We will monitor the competitive dynamics between Amazon and Shopify and how it affects unit economics (we own shares in both firms). Amazon is a strong competitor. However, Shopify continues to innovate.

First, Amazon does not have the same product DNA as Shopify. Ruthless execution allowed Amazon to build one of the world's best logistics networks. However, just like at AWS, the culture a business needs to excel at one thing may not necessarily be the one that is required to build the most user-friendly interfaces and APIs.

Second, Amazon's service comes at a price which reduces margins and can increase complexity. Merchants that use Fulfilment by Amazon (FBA) can pay up to 30% plus advertising costs and still need to do inventory management and reporting.

Third, merchants that prefer to own the customer relationship are unlikely to put all their eggs in one basket. The direct-to-consumer strategy is evolving into a connect-to-consumer approach in which merchants are exploring multi-channel pathways to reach customers. For instance, Kylie Jenner is using TikTok Shopping, a new partnership with Shopify, that allows users to link TikTok accounts to their online stores, enabling her 48m followers to buy from Kylie Cosmetics on the platform. Shopify's orders on social media channels multiplied in 2022. The opportunity extends to other platforms like YouTube and NFTs that unlock offers. Shopify's opportunity is to further grow the platform to enable the channel-agnostic strategies (Shopify's offline GMV grew 35% YoY in 2022 Q3).

Fourth, global commerce is too big for one winner and Shopify keeps innovating. In 2022, it launched Shopify Audiences that allows merchants to create digital audiences in order to increase conversion and return on ad spend. In 2022, Shopify acquired Deliverr for USD 2.1bn to create a more robust logistics platform. It is too early to tell how successful this will be. Last year, both Amazon and Shopify gained market share in retail commerce and 2023 will show more facts that allow us to understand how Buy with Prime is affecting Shopify's business.

Google Search versus ChatGPT and Shopify versus Amazon are examples of the constant chess game at the frontier of technology. Innovation will somehow positively or negatively affect the moat of our companies. The investor needs to filter the noise from the important developments and will make mistakes in judgement along the way.

Growth Premium

Valuations have logically come down driven by higher interest rates and lower growth expectations. However, sentiment may have turned too negative; the spread between the S&P 500 earnings yield and 10-year *real* interest rates shows that equity valuations are attractive in general. Hundreds of American companies in various industries are trading at or below the net cash on the balance sheet, and several fine tech businesses are trading around 1-4 times revenues.

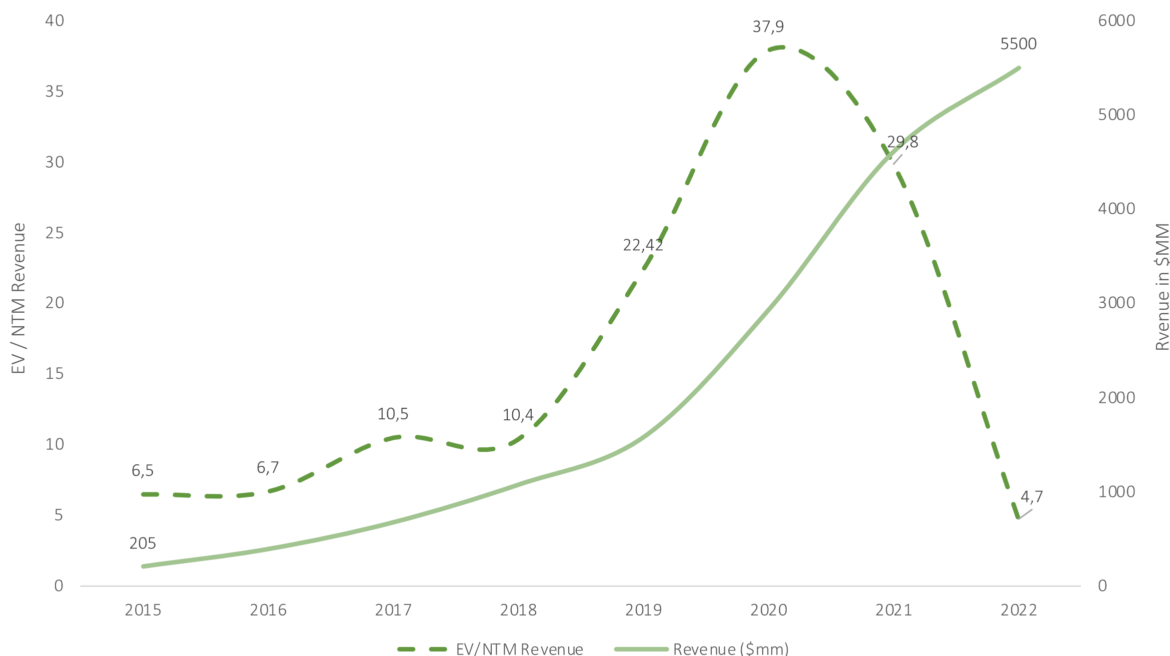
The fear about growth and profitability is reflected in prices; the growth premium of high-quality enterprise software businesses with leading positions in their respective fields has vanished. For instance, Snowflake's forward 2024 enterprise value/revenue multiple is about 10x versus 7.3x for Autodesk. The forward EV/revenue multiples of Datadog, Gitlab, and Cloudflare, are comparable with the 7x for Microsoft. The best 'growth' stocks have become attractive unless growth is permanently gone.

Microsoft is generating tons of FCF, part of which is being returned to shareholders. In contrast, the investor needs a view on how FCF margins will ramp up at various companies that are still relatively early in their S-curve. Nonetheless, the opportunity cost of owning big tech versus the best younger-generation platforms has increased. We believe that the market will continue to value growth (in addition to earnings) and some of the businesses in the table below deserve to trade at a more significant valuation premium even if operating margins still need to improve. The absence of a valuation premium at some of the best businesses that are likely to multiply their business over the next decade seems a rare opportunity.

Name	Market Cap ($Bn)	EV ($Bn)	NTM Rev Growth	EV/NTM Rev Multiple	EV/2024 Rev Multiple	Growth Adjusted EV/NTM Revenue	Gross Margin	FCF Margin	GCM Estimated FCF Margin at Scale	Net Cash ($Bn)
Snowflake	45.7	42.0	46%	15.5	10.0	0.34	65%	21%	30%	3.7
Cloudflare	14.2	14.2	37%	11.6	8.1	0.31	77%	-5%	20%	0.0
Crowdstrike	23.2	21.5	36%	7.8	5.6	0.22	74%	31%	25%	1.7
Shopify	39.6	36.0	20%	5.7	4.4	0.29	50%	1%	20%	3.6
Datadog	22.0	21.0	33%	10.3	7.2	0.31	79%	26%	25%	1.0
Confluent	5.7	5.0	33%	6.9	5.0	0.21	64%	-20%	20%	0.7
Roblox	20.0	18.0	10%	8.2	6.9	0.82	78%	-4%	20%	2.0
Spotify	17.8	16.2	16%	1.3	1.0	0.08	26%	3%	15%	1.6
Gitlab	6.7	5.8	43%	10.6	7.2	0.25	88%	-19%	25%	0.9
Alphabet	1,196.0	1,071.0	12%	3.8	3.4	0.32	57%	26%	30%	125
Microsoft	1,783.0	1,724.0	11%	7.6	7.0	0.69	68%	33%	33%	59
Autodesk	43.1	44.3	9%	8.3	7.3	0.92	90%	38%	35%	-1.20
Average	**268.1**	**251.6**	**25%**	**8.1**	**6.1**	**0.35**	**68%**	**11%**	**13%**	**18.1**
Median	**22.0**	**21.0**	**33%**	**7.8**	**6.9**	**0.31**	**68%**	**3%**	**25%**	**1.8**

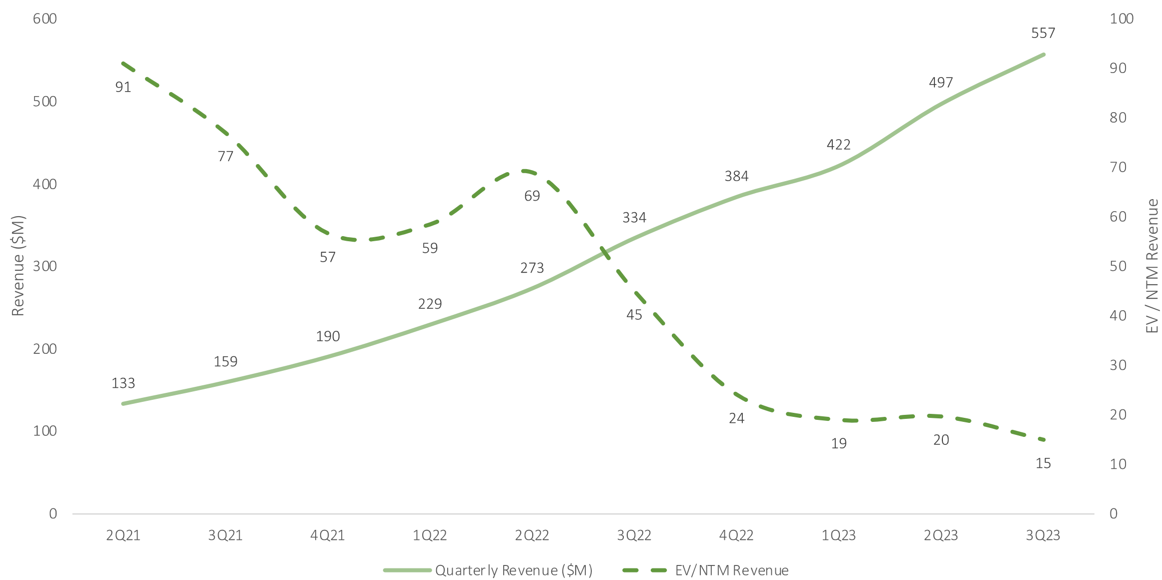
Source: Clouded Judgement, Company filings

The graph below shows how the valuation of Shopify expanded and contracted over the past years. The peak valuation in 2020 was too high given lower growth in 2022. As the share price was flat in 2021, the valuation already started to decline over 2021. The current price is low if growth proves to be durable.



Source: Company filings

The same illustration for Snowflake shows how revenues continue to grow and how the EV/NTM Revenue multiple has come down. The current price is not far from what Berkshire Hathaway paid pre-IPO while Snowflake's business has multiplied since.



Source: Company filings

The graph below of Amazon's gross profit yield is a fitting example of how the earnings yield of a fine business has increased (Amazon's share price declined by 50% in 2022). In the fourth quarter of 2022, we bought shares of Amazon at a price that basically reflects the value of AWS and the advertising business. Amazon's stock is likely to double in 3-4 years. Nonetheless, we think that the biggest gains over the coming three years will be made owning shares of younger-generation tech companies.

Source: Bloomberg

Not all portfolio businesses were trading at a rich valuation in 2021. For instance, Spotify's share price declined 66% in 2022 from a price that was reasonably attractive. As of Q3 2022, monthly active users grew by 20% YoY to 465 million and revenues grew 21%. The market is skeptical if Spotify can increase margins. Indeed, in 2023 we need to see evidence that it is on a path towards management's 40% gross profit target. However, at about 1x forward revenues, the success of this investment is independent of sentiment in capital markets. The valuation is cheap unless the business implodes for which we see no evidence. Spotify has USD 1.6 billion net cash and is generating FCF while investing in their future.

The Coming Years

We must be careful not to draw the wrong conclusions.

What has changed is our awareness of valuations. We need to be more disciplined to sell if multiples reflect too much optimism. The balance between letting the great businesses run and selling based on valuation will be delicate and a source of future mistakes.

What has not changed is that we will invest in public businesses from the perspective of co-owners. We are not traders, and this means we must be prepared to go down as much as the market will push down the prices of stocks in various future market swings. It is not adverse macroeconomic events that derail compounding but rather investor's reactions to them.

We do not hedge volatility. The focus continues to be on trying to understand the quality of an individual business. To participate in the wealth creation of the world's best tech businesses, the investor must be comfortable owning such businesses at full valuation. The best companies will not trade at screamingly attractive valuations and if so, just for a limited time. We think that letting the winners run continues to be the right approach.

What has not changed either is our focus on the companies that are driving innovation and are pushing the frontier of science and technology. Over the past twelve months, we sometimes wished we had a portfolio consisting of Berkshire Hathaway, Hermes, and Coca-Cola. Hermes and Coca-Cola have something few businesses have: tremendous pricing power. This allows those companies to grow earnings even if the market does not expand. We are curious to see more evidence of pricing power at various tech businesses.

Going forward, we continue to own businesses that are early in their lifecycle and that have the luxury to reinvest all operational cash flows back into the businesses at attractive expected returns.

Portfolio

Operational developments remain solid and all companies are independent of capital markets; they are financing growth from cash flows and have plenty of cash.

We think that growth will be lower in 2023 and that long-term growth is likely to surprise. Most of the portfolio businesses continue to have strong tailwinds from expanding markets. For example, most organizations have just started to adopt cloud architectures and global cloud spent is estimated to 3-5x before 2030.

Part of the revenue growth at the companies is coming from better monetization of the existing client base. The land and expand strategy and pricing based on consumption rather than SaaS pricing based on 'seats' will enable businesses like Snowflake to keep growing as volumes continue to increase. The scalability of such a business model is more comparable to AWS than to that of a SaaS vendor. For instance, Capital One's spent on Snowflake went from USD 3m to USD 45m in three years.

The top positions are largely comparable to six months ago. We sold a few positions and reinvested the capital mostly in other portfolio businesses whose market prices came down as well and where we have a stronger feeling about unit economics in an inflationary world. The companies we sold (e.g., Palantir) continue to march ahead and seem to have a bright future ahead.

In 2022, Tesla's share price declined by 65% and we initiated a position in December 2022. There is no lack of big opinions about either Elon Musk or electric cars. We see Tesla as an AI robotics company that can leverage its insights from developing autonomous driving for robotics. In addition, Tesla is a promising energy business and energy tech is probably among the most interesting fields over the coming decade. Tesla's energy business is about 5% of total revenue and contributed zero to profits in 2022. In 2022 Q4, Tesla Energy's factory in Lathrop in California went into production. This plant will produce Tesla Megapacks to serve demand for large-scale energy storage systems. For instance, the state of Hawaii is moving towards sustainable energy and is closing their coal-powered electric power plant. Tesla Megapacks are helping to build a grid in Hawaii. So far, this is only one factory which took one year to build and is likely to contribute about USD 15 billion to gross profits by the end of 2023.

In 2022, the share price of Datadog, a leading monitoring and security platform for cloud applications, declined by 59%. Over the first nine months of 2022, revenue grew 72%. With 78% gross margins, a 26% free cash flow margin, and USD 1bn net cash, Datadog is well-positioned to benefit from the growing observability market as the penetration of companies that are using modern observability software is rising from about 20% to above 50% in the near-term. We bought shares of Datadog in the fourth quarter of 2022.

Often, when we research a young software business, we realize that the true winner is AWS or Azure because the house always wins. Currently, Alphabet and Amazon seem cheap compared to most other assets. At the same time, we do not manage tens of billions of assets, and therefore do not need to invest only in the large cap businesses. We think several younger companies are likely to compound faster over the coming decade especially now the risk-adjusted returns have become attractive.

Miscellaneous

If capital is abundant, respect for capital goes down. If capital becomes scarce, then respect goes up. That in short, sums up most of what we have experienced over the past twelve months.

The technology sector was the first to experience a sell-off and is likely to rebound before general indices, which often are far ahead of the general economy. In the credit crisis, the Nasdaq 100 bottomed on November 12, 2008, while the S&P 500 bottomed on March 9, 2009. Other sectors just started to slow down in 2009 and real estate bottomed in 2013.

We do not know when prices will rebound. At some point sentiment will change again. Bill Miller was right when he said: ‘Most of the returns in stocks are concentrated in sharp bursts beginning in periods of great pessimism or fear.’

Most stress in 2022 came from dealing with the emotions of people rather than markets. We feel responsible for our partners investments in the funds and are sorry for the rollercoaster that even we did not expect to be so wild. We are curious how we will reflect on 2022 in a couple of years.

The fact that we will not trade based on macroeconomic expectations essentially means that our fund is not for everyone. There are plenty of other market participants with products that cater to the demand for low volatility. It is unlikely that we will ever experience such a large portfolio drawdown again also because it is improbable that interest rates turn negative again and valuations expand as much as they did in 2020. However, over the coming decade, we will experience our fair share of volatility.

Few investors generated generational wealth by owning Amazon shares because it was never easy to hold the shares while the valuation appeared rich and through multiple material drawdowns. The Forbes 400 of richest Americans is full of business owners who kept owning their companies despite going through adverse times.

We admire the temperament of the investors who were willing to invest additional capital over the past year. Most were early like we were ourselves. It is the right mindset, and we are feeling the responsibility to perform. Do not hesitate to contact us with any questions.

In 2023, we will share a quarterly investment report in April and a semi-annual letter in July.

Our plan for 2023 is to continue our investment work with curiosity and inquiry.

Sincere regards,

Also on behalf of Felicia, Martin,

Georg

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